IFRS 17 *Insurance Contracts*
Issues raised by the insurance industry

Objective

1 The objective of this paper is to provide the views of EFRAG TEG on the issues raised by the insurance industry as discussed during the EFRAG TEG meeting of 25 July 2018.

Background

2 Insurers that provided responses to the full and simplified case studies provided a combination of evidence (quantitative and qualitative) and views on the effects of IFRS 17 *Insurance Contracts* and its acceptability in its current form. The CFO Forum presented its members' analysis of the key findings/concerns from the case study to the EFRAG Board on 3 July. This presentation was made available to EFRAG TEG as agenda paper 05-05 for the meeting on 5 July 2018[1].

3 The EFRAG Board requested an analysis of the issues for consideration at a future meeting. Accordingly, the EFRAG Secretariat has prepared analyses of the issues and then obtained the views and agreement from EFRAG TEG at the meetings of 25 July. The analyses summarise the relevant requirements of IFRS 17 and include evidence from the case studies.

List of issues

4 The list of issues raised in the presentation to the EFRAG Board are:

(a) Measurement:

(i) Acquisition cash flows;

(ii) CSM amortisation;

(iii) Discount rates

(iv) Multi-component contracts;

(v) Reinsurance;

(vi) Scope of hedging adjustment;

(vii) Scope of the VFA vs General Model and PAA;

[1] The CFO Forum has since written to the President of the EFRAG Board and to the Chairman of the IASB calling for IFRS 17 (and IFRS 9) to be re-opened to address the CFO's Forum's concerns prior to endorsement.

(viii) Transition;

(b) Operational complexity:

(i) Business combinations;

(ii) Level of aggregation;

(iii) Presentational issues;

(c) Other implementation challenges:

(i) Pressure on implementation timeline.

Note to EFRAG TEG

This paper contains the issues discussed in the EFRAG TEG meeting on 25 July 2018. It will be updated for the issues to be discussed at the meeting on 8 August.

5 The CFO Forum also raised the issue of costs. This will be the subject of a separate paper.

Approach to each issue

Description of issue and evidence as well as Implications

6 The wording under the heading CFO Forum Presentation for each issue has been taken from the CFO Forum presentation on 3 July.

Evidence from the case studies

7 The evidence from the case studies must be read in the light of the fact that case study participants made their best endeavours, but without fully developed systems to support their work. This required the use of shortcuts and approximations, given the time available. Further, the accounting policies used in the case studies and the IFRS 17 options selected may change as further analysis and information becomes available.

8 In the analysis, the evidence from the case study is derived from the full case study unless specifically mentioned that the evidence came from the simplified case study. The evidence from the case study included in this paper is necessarily summarised and therefore not comprehensive (but is intended to be representative).

MEASUREMENT

1. Acquisition cashflows

CFO Forum Presentation

Description of issue and evidence

9 Acquisition cash flows on new business that is expected to renew cannot be allocated to future periods. This is inconsistent with other industries which capitalise acquisition costs over multiple contracts. This was particularly evidenced in the testing of P&C contracts.

Implications

10 This results in incorrect matching of income and expenses over time. The implications are intensified if the inability to allocate acquisition costs to future periods results in contracts being onerous in accounting (but not in economic reality).

IFRS 17

Requirements

Definition of acquisition costs

11 Cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

IFRS 17, paragraphs 27, 38

12 Acquisition cash flows are initially capitalised (unless the entity elects to recognise them immediately in profit or loss under the PAA). They are included in the CSM of a group of contracts to which they relate when that group is recognised.

Basis for Conclusions

IFRS 17, paragraph BC176

13 The IASB concluded that such an asset either does not exist or relates to future cash flows that are included in the measurement of the contract. The Board noted that an entity typically charges the policyholder a price the entity regards as sufficient to compensate it for undertaking the obligation to pay for insured losses and for the cost of originating the contracts. Thus, a faithful representation of the remaining obligation to pay for insured losses should not include the part of the premium intended to compensate for the cost of originating the contracts.

Findings from the case study

14 Number of respondents addressing the issue: 2.

15 Of the comments received:

(a) One respondent illustrated the impact of the treatment of acquisition costs relying on a property and casualty portfolio. The respondent found limited losses on onerous contracts, while demonstrating an overall profit on the line of business (the results were based on a combination of two portfolios). The respondent noted that the pricing reflects expected renewals.

(b) One respondent described the situation for property and casualty business where acquisition costs are unconditionally paid, i.e. without any claw-back clause if the contract is not renewed after the first year. The respondent notes there are strong historical records of persistence of the contracts (i.e. many of the policyholders continue the contract beyond the first year). Hence, the respondent argues that the economic duration of the contracts is longer than the contract boundary as defined in IFRS 17. This respondent quantified the difference between assigning the acquisition costs to new clients only, or to new clients and renewals. The respondent found that attributing acquisition costs to new clients only can lead to more onerous contracts. Further, this respondent noted that renewals can indirectly impact pricing as profitability assumptions are based on the expectation that contracts will be renewed over several years.

This respondent provided the following calculations for its portfolio (for reasons of confidentiality, the impact is reported in percentages).

Acquisition costs allocated to	**A. New clients only**	**B. Renewals only**	**A+B New business (new clients and renewals together**
Pretax profit	(75%) negative	175% (positive)	100% (overall positive)

Explanation: when acquisition costs are allocated to the new business in their entirety (new clients and renewals together), the portfolio is overall profitable. However, when the acquisition costs are allocated partly to new clients and partly renewals, the allocation to new clients becomes onerous. Also, what can be drawn from this example is that the major part of the acquisition costs is attributed to renewals of the contracts from a commercial perspective.

EFRAG TEG analysis

16 EFRAG TEG acknowledges that, from a commercial perspective, an insurer's decision to pay a certain level of acquisition costs might take into account its expectation of contract renewals. EFRAG TEG also acknowledges that some contracts will be treated as onerous due to the allocation of acquisition costs to them.

17 Some insurers have raised concerns about the different treatment of similar costs under IFRS 17 compared to the treatment in IFRS 15 *Revenue from Contracts with Customers*. The following differences between the two Standards are noted:

(a) The scope and definition of acquisition costs under the two Standards differ, with IFRS 17 including a wider range of expenses compared to IFRS 15[2].

(b) Expenses capitalised under IFRS 15 are subject to amortisation on a systematic basis over a period that can include expected renewals of the existing contract. Under IFRS 17, the acquisition costs reduce the CSM at inception and are effectively recognised through the amortisation of the CSM over the coverage period as established by the contract boundary.

(c) Contract costs under IFRS 15 are subject to annual impairment testing whereas, under IFRS 17, recoverability is dealt with by the onerous calculation for the groups of insurance contracts.

[2] For contract costs, IFRS 15 refers to incremental costs compared to costs that are directly attributable under IFRS 17. IFRS 17 also includes costs not directly attributable to individual contracts or groups of insurance contracts within a portfolio e.g. cash flows related to both successful and unsuccessful acquisition activities which is not the case under IFRS 15.

(d) The unit of account for IFRS 15 is an individual contract or performance obligation whereas for IFRS 17 it is a group of insurance contracts.

18 EFRAG TEG notes that eliminating the differences between IFRS 15 and IFRS 17 would require significant changes. IFRS 15 treats these costs as a separate unit of account but IFRS 17 treats them as a cash flow of the of group of insurance contracts. The acquisition costs are dependent on the underlying business and viewing them as a separate 'unit of account' would create knock-on effects.

19 EFRAG TEG notes that considering behavioural estimates of renewals cannot be seen in isolation from the type of acquisition cash flows that are deferred. The costs deferred under IFRS 15 are specific and incremental to a particular contract, while under IFRS 17 they are directly attributable to a portfolio of contracts. The narrower scope of costs deferred under IFRS 15 goes hand-in-hand with the recognition of a separate asset. Considering behavioural estimates of renewals under the IFRS 17 model would require extending the contract boundary beyond the contractual contract boundary and thus require recognition of fulfilment cash flows over the expected renewal period.

20 Further, EFRAG TEG notes:

(a) Behavioural estimates indicate the proportion of the population of policyholders are expected to renew their insurance contract, but not which individual policyholder will renew or not.

(b) Based on the results from the case study, renewals of insurance contracts are generally not considered in pricing of the life and health business. In contrast, renewals are considered by some insurers in pricing in the property and casualty business.

(c) In addition to the results from the case study, EFRAG TEG has been informed that renewals also play a role for some unit-linked contracts that are subject to repricing at short time intervals;

(d) IFRS 17, paragraph 106 (b) requires disclosure of the allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flows;

(e) US GAAP defines acquisition costs as those that are related directly to the successful acquisition of new or renewal insurance contracts. Under US GAAP, acquisition costs are deferred and amortised based on different amortisation methods. As part of the proposed changes to the requirements for long-duration contracts, deferred acquisition costs would be amortised on a constant basis over the expected life of the related contracts. Deferred acquisition costs would be written off for unexpected contract terminations but would not be subject to impairment testing.

(f) Insurers price their contracts to recover all acquisition costs. As a result, the CSM would be overstated if unsuccessful acquisition costs were not considered.

21 Based on the above considerations, EFRAG TEG notes:

(a) It has been argued by some that the treatment of deferred acquisition costs under IFRS 17 should be aligned with the treatment under IFRS 15, thereby considering future renewals of insurance contracts when amortising acquisitions costs. EFRAG TEG notes that insurers estimate the renewals of their insurance contracts at a higher level of aggregation, not at individual contract level as is the case in IFRS 15. Aligning the two standards would require changes to IFRS 17 by limiting which costs could be classified as acquisition costs as well as changing the amortisation pattern, which would add complexity.

(b) It has been argued by some that presenting particular groups of insurance contracts as onerous as a result of the inclusion of acquisition costs is misleading as the insurer expects these contracts to be profitable because of the renewals. EFRAG TEG acknowledges that the presentation of groups of insurance contracts including acquisition costs is a significant difference compared to today's practices. As a result, it will require an adaptation period for users of financial statements to get acquainted with the new presentation.

22 Based on the above, EFRAG TEG is of the view that the treatment of deferred acquisition costs in IFRS 17:

(a) Contributes to the provision of relevant information as the amount of the costs that are taken into account in measuring the initial group of insurance is in line with the business decision to pay acquisition costs in the expectation of renewals, without having the ability to control these renewals. Hence, this is also reflects management stewardship;

(b) Contributes to the provision of reliable information as expected renewals are not under the control of the insurer and so the recovery of acquisition costs is not certain;

(c) Adds to comparability, as the disclosure of the recovery of insurance acquisition cash flows allows to compare how much acquisition costs different insurers assign to their respective business.

~~21~~23 EFRAG TEG notes expensing the acquisition costs either immediately or over the contract period contributes to prudence.

~~22~~24 Based on the above considerations, EFRAG TEG considers that IFRS 17's treatment of acquisition costs will contribute positively to the technical endorsement criteria (relevance, reliability, comparability and prudence).

2. CSM Amortisation

CFO Forum Presentation

Description of issue and evidence

~~23~~25 The requirements on coverage units to be used for the CSM amortisation are not appropriate for all types of contracts. A key issue is that the CSM (of which the initial amount is impacted by investment spreads) cannot be amortised over the period in which investment services are provided. This issue was mainly identified in the testing for savings and participating contracts. It is acknowledged that this is a topic under discussion by the IASB for contracts in scope of the VFA. However, the issue is equally relevant for the general measurement model.

Implications

~~24~~26 Profit recognition over the life of the contract is not appropriate. For certain contracts, profit recognition is strongly frontloaded or backloaded. For example, on a simple annuity contract profit is not appropriately recognised in the accumulation and deferral phases.

IFRS 17

Requirements

IFRS 17, paragraphs 44 (e) and 45 (e)

27 For insurance contracts without direct participation features, the carrying amount of the CSM of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for, among other items, the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the CSM remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period applying paragraph B119.

28 …For insurance contracts with direct participation features, the carrying amount of the CSM of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for, among others, the amount recognised as insurance revenue because of the transfer of services in the period, determined by the allocation of the CSM remaining at the end of the reporting period (before any allocation) over the current and remaining coverage period, applying paragraph B119.

IFRS 17, paragraph B119

~~25~~29 The CSM for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period.

Basis for Conclusions

IFRS 17, paragraph BC279 – BC283

~~26~~30 Insurance coverage is the defining service provided by insurance contracts. The amount is determined by identifying the coverage units in the group. The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

31 The IASB considered whether the allocation of the CSM based on coverage units would result in profit being recognised too early for insurance contracts with fees determined based on the returns on underlying items. For such contracts, IFRS 17 requires the CSM to be determined based on the total expected fee over the

duration of the contracts, including expectations of an increase in the fee because of an increase in underlying items arising from investment returns and additional policyholder contributions over time. The IASB rejected the view that the allocation based on coverage units results in premature profit recognition. The IASB noted that the investment component of such contracts is accounted for as part of the insurance contract only when the cash flows from the investment component and from insurance and other services are highly interrelated and hence cannot be accounted for as distinct components. In such circumstances, the entity provides multiple services in return for an expected fee based on the expected duration of contracts, and the IASB concluded the entity should recognise that fee over the coverage period as the insurance services are provided, not when the returns on the underlying items occur.

32 The IASB also considered a proposal to constrain the amount of contractual service margin recognised in an accounting period just as IFRS 15 constrains the recognition of revenue. The approach would have constrained the cumulative amount of the CSM that the entity recognised in profit or loss to the amount to which the entity is reasonably assured to be entitled. However, in the IASB's view, it would be inconsistent with other aspects of IFRS 17 to constrain the amount of CSM on a 'reasonably assured' basis. IFRS 17 requires a current measurement model based on a probability-weighted average of all possible scenarios and the CSM depicts a current view of the unearned profit relating to services consistent with that measurement model.

33 IFRS 17 requires the contractual service margin remaining at the end of the reporting period to be allocated equally to the coverage units provided in the period and the expected remaining coverage units.

Findings from the case study

~~27~~34 Number of respondents addressing the issue: 7.

~~28~~35 For 10 of the 26 portfolios tested under the General Model, concerns were raised that investment services should be considered in CSM amortisation by 7 respondents. Of these 10 portfolios, 8 were annuity products, the remainder was an indirect participating contract and a savings type product. Information about the CSM release per cohort was not provided for these products.

~~29~~36 One respondent calculated the CSM release based on actual insurance cash flows as suggested by the TRG, i.e. CSM release only during the insurance coverage period of the annuities. In this case more than 60% of the CSM was released over years 25-30 of a 30-year annuity contract.

~~30~~37 One respondent to the simplified case study explained that for some products the insurance risk is provided over a shorter period than the contract duration, potentially resulting in 'upfronting' the CSM release.

~~31~~38 Respondents expressed support for the proposed IASB amendment to IFRS 17 to include investment services when allocating CSM under the VFA.

EFRAG TEG analysis

~~32~~39 The IASB is proposing to amend IFRS 17 to clarify that, for VFA contracts, the services provided include investment services because of the explanation in paragraph B101 that these "are insurance contracts that are substantially investment-related service contracts … which … promises an investment return based on underlying items". IFRS 17 has a clear principle that provides relevant information that the allocation of the CSM to profit or loss is recognised in accordance with the services to be received by the customer. Consequently, this analysis focusses on the situation for contracts under the General Model as per the CFO Forum presentation.

40 EFRAG TEG notes that a contract could fail to qualify for the VFA even if only one of the requirements in IFRS 17 paragraph B101 is not met and that the issue of CSM allocation is closely linked to that of scope of the VFA as discussed in Section 7. Furthermore, some contracts may include participation features (so-called indirect participation contracts) but not meet the requirements of the VFA. Some regard this representation of performance as inadequate, but others consider that if there is no specific linkage to assets, it is inappropriate to only focus on business model.

41 EFRAG TEG further notes that insurance contracts may contain one or more distinct components that are to be accounted for under other standards. IFRS 9 *Financial Instruments* is to be applied to a distinct investment component allowing the recognition of profit relating to investment services over time, while IFRS 15 is to be applied to non-insurance services provided to a policyholder.

~~33~~42 For non-VFA contracts, it is not clear when and how any investment service provided should be identified and included in 'services provided' for the purpose of determining the pattern of CSM release. In some cases, the insurer may consider the service to include investment services, but the policyholder would not necessarily regard it as such. For example, with the purchase of a deferred annuity, the insurer will need to carefully manage the investment to ensure it can honour its obligations under the annuity contract, however, the policyholder is not concerned about the intervening period, but only the outcome, i.e. the receipt of the annuity as agreed.

~~34~~43 EFRAG TEG acknowledges that, for some products, an insurer receives and invests premiums before the start of the insurance coverage period in accordance with the business model but, under IFRS 17 may not recognise any revenue during this period. In such a case, EFRAG TEG considers that the insurer's investment activity is not a service provided to the policyholder. An analogy can be made with IFRS 15's guidance on activities that are necessary to fulfil a contract but do not transfer a service to the customer.

~~35~~44 EFRAG TEG does not support an extension of the investment services concept to non-VFA contracts as it is questionable whether there is a clear link between the promise to the policyholder and the provision of an investment service. To do so would imply a linkage that does or may not exist. If no specific investment service to the policyholder can be identified, including investment activity in determining the CSM release pattern does not lead to relevant information.

~~36 The EFRAG Secretariat questions whether any "true" profit pattern can be known. Often respondents compare the outcome under IFRS 17 to the profit pattern under current GAAP(s) and question the need to change that pattern. However, currently the patterns are not comparable given the significant differences in current practices. IFRS 17 sets out an overall principle that (in the view of the EFRAG Secretariat) will contribute to relevance and comparability while also requiring the use of judgement to adapt to specific fact patterns.~~

~~37~~45 Based on the above considerations, EFRAG TEG considers that IFRS 17's requirements on CSM amortisation will contribute positively to the technical endorsement criteria of relevance and comparability while also requiring the use of judgement to adapt to specific fact patterns.

3. Discount rates

CFO Forum Presentation

Description of issue and evidence

~~38~~46 The use of a locked in discount rate for the CSM in the general model. The impact of assumption updates is absorbed in the CSM at the locked-in rate. The BEL[3] is measured at the current rate. The difference between the locked-in and the current rate is reflected in the P&L and will significantly distort the current period result.

~~39~~47 In the situation where the BEL component of the insurance liability is an asset and the CSM component is a liability, inconsistencies arise due to the different discount rates for BEL (current rate) and CSM (locked-in rate).

~~40~~48 There is currently uncertainty regarding whether changes in asset mix will result in changes to the discount rate when the discount rate is determined top down using actual assets as a reference portfolio.

Implications

~~41~~49 For the issue referred to in paragraph 38 above, the result is significantly distorted by the discount rate components of the impact of assumption changes that are otherwise absorbed in the CSM.

~~42~~50 For the issue referred to in paragraph 39 above, the P&L and/or OCI is distorted by the use of different discount rates for different components of the insurance liability. This is particularly exacerbated when the BEL component is an asset.

~~43~~51 In the situation referred to in paragraph 40 above, an interpretation of the reference portfolio that appropriately reflects the asset/liability matching strategy is key to avoid significant levels of spurious volatility.

IFRS 17

Requirements

IFRS 17, paragraphs 36, 44, B72(b)

~~44~~52 The discount rates applied to the estimates of the future cash flows shall reflect the time value of money, the characteristics of the cash flows and the liquidity characteristics of the insurance contracts; be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity; and exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance.

~~45~~53 For insurance contracts under the general model, the carrying amount of the CSM of a group of contracts at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for (among others): interest accreted on the carrying amount of the CSM measured at the discount rates determined at the date of initial recognition of a group of contracts,

Basis for Conclusions

IFRS 17, paragraph BC201

~~46~~54 To the extent that the cash flows that arise from the contracts are expected not to vary with returns on underlying items, the appropriate discount rate should exclude any factors that influence the underlying items that are irrelevant to the contracts.

[3] Best Estimate of the Liability

Such factors include risks that are not present in the contracts but are present in the financial instrument for which the market prices are observed. Thus, the discount rate should not capture all of the characteristics of those assets, even if the entity views those assets as backing those contracts.

Findings from the case study

~~47~~55 Number of respondents addressing the issue: 5. Of those participants:

(a) One respondent estimated the pro-forma P&L impact of an annuitant mortality assumption change for 2017 under IFRS 17 (the actual improvement in life expectancy was less than originally expected). Assuming the use of modified or full retrospective approach and given differences in discount rate, about a quarter of the amount would have been recognised in P&L.

(b) Another respondent estimated that when testing sensitivity of results to changes in longevity (also for annuity products), a significant amount would be recognised in insurance finance expense given the larger impact on the liability compared to the CSM (in a decreasing interest rate environment). This is when not using the OCI option for interest rate changes.

(c) One respondent reflected the impact of changes to the risk-free interest rate on the balance sheet of an Asian business where the BEL is in an asset position. The equity balance increased by 22% or decreased by 19% with a 1% increase or decrease in the risk-free rate respectively.

(d) Another respondent expressed the concern above and referred to sensitivity of its annuity portfolios where a 50bps change in asset spread change (with no change to the reference portfolio or the discount rate) would result in a 671% negative change to profit before tax.

(e) One respondent commented that a 12% difference in the net finance result was due to the calculating interest on the CSM at the locked-in rate and that this does not reflect the financial performance of the insurance contracts.

EFRAG TEG analysis

~~48~~56 EFRAG TEG notes that the issue of locked-in versus current rates for the CSM (both in the interest accretion and when updating for changes in estimates) impacts relevance and prudence. The CSM is a “cost-based” deferral that avoids a day 1 gain and provides a mechanism to allocate profit over the insurance overage period. There are also other considerations.

~~49~~57 In the extreme example where only interest rates change (with no other changes), the CSM and related amortisation would change if the CSM is accreted at current rates. This does not appear to provide relevant information or to be prudent. This would also mean that the changes in discount rate that ought to be treated as investment result, would be reported in the underwriting result through the release of the CSM.

~~50~~58 However, as explained in paragraph 47 (a) and (b) above, respondents expressed concern about the (in their view) anomalous result when a change to a technical assumption could impact the profit or loss due to different interest rates being used for the fulfilment cash flows and the CSM.

~~51~~59 A further consideration is the operational complexity of having to use a historic rate for some parts for one of the models and the related costs. No information was provided on the impact on costs by the case study respondents.

60 EFRAG TEG considers the technical arguments for use of a locked-in rate on the CSM under the General Model compelling and specifically views the consistency with the rest of IFRS Standards in relation to deferred profit as important.

~~52~~61 EFRAG TEG also notes that where preparers choose to disaggregate finance results between the profit or loss and other comprehensive income, they would need to track historic rates. EFRAG TEG also considers that a separate question around the cost benefit of the requirements will form part of Appendix 3.

4. Multi-component contracts

CFO Forum Presentation

Description of issue and evidence

~~53~~62 Certain contracts exposing the issuer to credit risk that are in substance loans (for example equity release mortgages in the UK) contain a small insurance element which causes the entire contract to be subject to insurance accounting under IFRS 17.

Implications

~~54~~63 Including these products in the scope of IFRS 17 is inconsistent with the treatment of similar products in other industries.

IFRS 17

Requirements

Definition of insurance contract

~~55~~64 An insurance contract is a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future.

IFRS 17, paragraphs 10, 11

~~56~~65 An insurance contract may contain one or more components that would be within the scope of another Standard if they were separate contracts. For example, an insurance contract may include an investment component or a service component (or both). An investment component is separated from a host insurance contract only if that investment component is distinct.

Basis for Conclusions

IFRS 17, paragraphs BC10, BC11, BC108

~~57~~66 If the IASB extended the scope of existing IFRS Standards to include insurance contracts, an insurer would need to identify investment components within each premium that it receives. The IASB decided that it would be difficult for an entity to routinely separate components of an insurance contract and setting requirements to do so would result in complexity. Such separation would also ignore interdependencies between components, with the result that the sum of the values of the components may not always equal the value of the contract as a whole, even on initial recognition.

~~58~~67 Overall, applying generally applicable IFRS Standards would provide useful information for users of financial statements and would be relatively easy to apply to insurance contracts for which there is no significant variability in outcomes and no significant investment component. This is because, in those cases, the issues arising with IFRS 15 and IFRS 9 would not occur. However, simply applying generally applicable Standards would be difficult and would produce information of limited relevance for other types of insurance contracts. In contrast, the model required by IFRS 17 can be applied to all types of insurance contracts.

Findings from the case study

~~59~~68 Number of respondents addressing the issue: 2

~~60~~69 Under current accounting, for the selected portfolios:

(a) Nine respondents did not separate any components.

(b) Two respondents separate guaranteed benefits and options under annuity contracts.

~~61~~70 Of the nine respondents that do not separate contracts currently:

(a) Two respondents are considering the need to separate hybrid contracts, riders on participating contracts and some guarantees on annuity contracts.

(b) Two respondents specifically noted the issue with regards to equity release mortgages. However, these loans were not part of their selected portfolios for the case study.

(c) Another respondent also raised concerns with regards to policy loans which will be deemed closely related to the insurance host contract under IFRS 17 but these loans were not part of their selected portfolios.

EFRAG TEG analysis

~~62~~71 EFRAG TEG notes that the definition of:

(a) an insurance contract is a principle-based definition which did not change with the introduction of IFRS 17; and

(b) the notion of "distinct" under IFRS 17 is consistent with IFRS 15 *Revenue from Contracts with Customers*.

~~63~~72 EFRAG TEG considers that the issue arises in part because, unlike in IFRS 4, entities are no longer permitted to separate ('unbundle') an embedded derivative that confers the insurance risk from an overall contract (unless the components are distinct). EFRAG TEG acknowledges that IFRS 4's greater flexibility in this area enables some entities to account for products such as equity release mortgages more simply than applying IFRS 17 (especially if the unbundled component was assessed to be immaterial).

~~64~~73 EFRAG TEG assesses that reintroducing an unbundling option would be a significant change, which would hinder comparability and add complexity. While IFRS 4 is very flexible in this area, a new unbundling solution would probably need to be much more tightly defined to meet the overall objectives of IFRS 17.

~~65~~74 Further, EFRAG TEG notes that IFRS 17 applies to all insurance contracts~~,~~ (except those who are scoped out under paragraph 7 of IFRS 17), whether the issuer is an insurer or not. The application of the 'significant insurance risk' principle to distinguish insurance contracts from financial instruments or IFRS 15 contracts should contribute to comparability. EFRAG TEG assesses that contracts with significant insurance risk are dissimilar to contracts without such risk. Scoping out particular contracts would be arbitrary and could add complexity. Also it is noted that the separation of other non-insurance components from an insurance contract under IFRS 17 is based on the principles of IFRS 15. Accordingly, IFRS 17 requires entities to separate only the goods and services that are distinct from the provision of insurance coverage.

75 EFRAG TEG notes that the IASB considered whether to permit an entity to separate a non-insurance component when not required to do so by IFRS 17; for example, some investment components with interrelated cash flows, such as policy loans. The IASB also noted that such components may have been separated under previous accounting practices. However, the IASB concluded that it would not be possible to separate in a non-arbitrary way a component that is not distinct from the insurance contract nor would such a result be desirable. Permitting an entity to separate such components would mean that the entity measures the components in the contract on an arbitrary basis. The IASB also noted that when separation ignores interdependencies between insurance and non-insurance components, the

sum of the values of the components may not always equal the value of the contract as a whole, even on initial recognition. That would reduce the comparability of the financial statements across entities.

~~66~~76 EFRAG TEG understands that the issue is potentially under consideration by the IASB's IFRS 17 TRG. Subject to any outcomes of a discussion and based on the above considerations, EFRAG TEG considers that a principle-based definition of insurance contracts continues to be needed. IFRS 17's scope and unbundling requirements contribute positively to the technical endorsement criteria (in particular comparability and understandability).

5. Reinsurance

CFO Forum Presentation

Description of issue and evidence

~~67~~77 The approach to reinsurance gives rise to several accounting mismatches. Examples include:

(a) For an underlying contract that is onerous, a cedant has to recognize a loss component through P/L whereas the relief from a corresponding reinsurance contract held has to be deferred over the coverage period.

(b) Reinsurance held cannot be accounted for under the VFA model, even if the VFA model is applied to the underlying insurance contracts.

(c) Contract boundaries for reinsurance are inconsistent with those of the underlying insurance contracts, meaning that the reinsurance accounting requires including an estimate of underlying insurance business that is not yet written/recognised.

Implications

~~68~~78 The inconsistencies between insurance and reinsurance accounting creates a number of accounting mismatches, meaning that the financial statements do not appropriately reflect the net risk position after reinsurance and, as a consequence, a distorted profit recognition pattern.

IFRS 17

Requirements

IFRS 17, paragraphs 47, 60, 69, B109

~~69~~79 An entity shall recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the contractual service margin of the group being zero.

~~70~~80 An entity may use the PAA (adapted to reflect the features of reinsurance contracts held that differ from insurance contracts issued for example the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of a group of reinsurance contracts held.

~~71~~81 Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of IFRS 17 and are thus accounted for in accordance with the general model.

Basis for Conclusions

IFRS 17, paragraphs BC298, BC299, BC311, BC313

~~72~~82 IFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This is because an entity that holds a reinsurance contract does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer. The IASB acknowledged that separate accounting for the reinsurance contracts and their underlying insurance contracts might create mismatches that some regard as purely accounting, for example on the timing of recognition, the measurement of the reinsurance contracts and the recognition of profit. However, the IASB concluded that accounting for a reinsurance contract held separately from the underlying insurance contracts gives a faithful representation of the entity's rights and obligations and the related income and expenses from both contracts.

~~73~~83 The amount paid for reinsurance coverage by the entity can be viewed as payment for:

(a) the reinsurer's share of the expected present value of the cash flows generated by the underlying insurance contract(s). That amount includes an adjustment for the risk that the reinsurer may dispute coverage or fail to satisfy its obligations under the reinsurance contract held.

(b) a CSM that makes the initial measurement of the reinsurance asset equal to the premium paid. This margin depends on the pricing of the reinsurance contract held and, consequently, may differ from the contractual service margin arising for the underlying insurance contract(s).

~~74~~84 The IASB concluded that the contractual service margin for the underlying group of insurance contracts should not be negative. However, IFRS 17 requires entities to instead recognise the negative difference over the coverage period of the group of reinsurance contracts held. The IASB was persuaded by the view that the apparent gain at initial recognition represents a reduction in the cost of purchasing reinsurance, and that it would be appropriate for an entity to recognise that reduction in cost over the coverage period as services are received.

~~75~~85 In the IASB's view, measuring the group of reinsurance contracts held on the basis of the premium the entity receives for the underlying contracts when that premium does not directly affect the cash flows arising from the group of reinsurance contracts held would be contrary to viewing the group of reinsurance contracts held and the underlying contracts as separate contracts. Such a measurement approach would also not reflect the economics of the group of reinsurance contracts the entity holds - that the expense of purchasing the group of reinsurance contracts (that should be recognised over the coverage period) equals the whole of the consideration paid for the group of reinsurance contracts.

Findings from the case study

~~76~~86 Number of respondents addressing the issue: 10

~~77~~87 Of the respondents providing information:

(a) Four respondents provided qualitative and quantitative input. Of these four:

   (i) Two respondents provided an example relating to protection business that is onerous and becoming profitable after considering external reinsurance. These respondents described that direct protection was written in collaboration of reinsurance partners for that reason.

   (ii) One respondent provided an example relating to a savings fund that was proportionally reinsured for 10%.

   (iii) One respondent supported the exclusion of reinsurance assumed from the VFA. However, for intercompany purposes the respondent deemed it beneficial for reinsurance assumed to mirror the mechanics of the underlying business.

(b) Five other respondents from the full case study and one respondent from the simplified case study provided qualitative comments on the inability to use the VFA for reinsurance assumed and reinsurance held.

~~78~~88 For reinsurance contracts held, five respondents mentioned the accounting mismatch, and raised concerns about the effect of intragroup reinsurance.

EFRAG TEG analysis

Reinsurance held for onerous contracts

~~79~~89 EFRAG TEG is sympathetic to the concerns about IFRS 17's accounting outcomes in cases when the effect of reinsurance is that the primary insurer is clearly in a net risk position. The rebalance and understandability of the reported information would be enhanced by showing the extent to which the risks have been offloaded to a third party. However, such a net risk position may exist when relying on some proportional reinsurance contracts (i.e. quota share treaties where the reinsurer covers a fixed proportion of every risk accepted by the direct insurer, no retention limits are applied), but does not arise when using other reinsurance contracts such as:

(a) Proportional, surplus treaty (i.e. the reinsurer only reinsures that portion of risk that exceeds the retention limit of the direct insurer); or

(b) Non-proportional reinsurance such as an excess of loss or stop loss reinsurance contracts.

~~*Reinsurance assumed*~~

~~80 When a reinsurer issues contracts that offset the risks/cash flows of direct participation contracts as defined in IFRS 17, the EFRAG Secretariat sees no principle against accounting for these contracts under the VFA. However,~~

~~(a) The EFRAG Secretariat has been informed that such contracts do not exist today, or are very rare;~~

~~(b) As contracts with direct participation contracts are basically pass-through contracts to the policyholder, a demonstration of the cash flows between the reinsurer, the direct insurer and the ultimate policyholder is required; and~~

~~(c) Further complexities of combining investment risk and insurance risk together need to be addressed (see below).~~

~~81~~90 EFRAG TEG acknowledges that an accounting mismatch can arise when an underlying contract is onerous and the cedant is required to recognise a loss component in profit or loss while the relief from a corresponding reinsurance contract held is be deferred over the coverage period.

~~82~~91 While being sympathetic to the "netting"- idea for particular reinsurance contracts held, EFRAG TEG notes that such "netting" does not remove the need for identification of onerous contracts. In case only 40% of the risks is being reinsured, the remaining 60% may still be onerous.

~~83~~92 In addition, a reinsurance contract only covers downside risk. When one of the risks covered is investment risk, issues arise such as:

(a) Is the premium paid to the reinsurer reduced when the underlying assets provide a return above initial estimates; or

(b) Can an insurance claim be compensated with a higher than expected investment return of the underlying assets, or is there discretion, and who initiates this discretion, the insurer or the reinsurer?

~~84~~93 EFRAG TEG acknowledges that the IFRS 17 requirements are an important change to the netting practices that prevail today in several local GAAPs. EFRAG TEG notes however that resolving the above issues could create additional complexity and might increase the costs of implementation.

~~85~~94 Based on the above considerations, EFRAG TEG considers that certain aspects of IFRS 17's requirements may detract from the technical endorsement criteria of relevance, reliability and understandability.

Reinsurance contracts held and issued and VFA

Reinsurance contracts held

95 In accordance with paragraph B109 of IFRS 17, reinsurance contracts held do not qualify as VFA contracts (contracts with direct participation features).

96 For reinsurance contracts held that meet the conditions to apply the VFA, this creates a mismatch with the underlying insurance contracts, when these are measured as contracts with direct participation features. EFRAG TEG notes that determination of the nature of the mismatch is more complex for contracts with direct participation features. For example, an economic mismatch may occur when the underlying investment returns are better than initially expected. As reinsurance covers the downside risk, a better than expected investment return of the underlying items would not necessarily result in an increased premium to the reinsurer.

97 Subject to the reinsurance contract and the underlying direct insurance contract having the same characteristics, EFRAG TEG acknowledges this mismatch does not result in relevant information. However, EFRAG understands that currently very few insurance contracts containing investment risk are reinsured, therefore EFRAG TEG assesses the potential impact of this mismatch to be rare.

98 EFRAG TEG is of the view that whether or not reinsurance contracts held are treated as insurance contracts with direct participation features does not affect the reliability criterion.

99 Based on the current netting practices in many local GAAPs between direct insurance contracts and reinsurance contracts held, EFRAG TEG acknowledges that understandability may be negatively affected when a VFA reinsurance contract cannot be treated as an insurance contract with direct participation features.

Reinsurance contracts issued

100 In accordance with paragraph B109 of IFRS 17, reinsurance contracts issued do not qualify as contracts with direct participation features.

101 EFRAG TEG understands that the request to apply VFA-accounting to reinsurance contracts issued relates to reinsurance contracts that share a substantial part of the underlying items between the ceding insurer and the reinsurer, including sometimes the sharing of asset returns.

102 EFRAG TEG assesses that where these reinsurance contracts fulfil all three criteria of insurance contracts direct participation features as defined under IFRS 17, the inability to apply VFA-accounting to these contracts reduces the relevance of the resulting information.

103 EFRAG TEG is of the view that whether or not reinsurance contracts issued are treated as insurance contracts with direct participation features does not affect the reliability criterion.

104 Based on the current netting practices in many local GAAPs between direct insurance contracts and reinsurance contracts issued, EFRAG TEG acknowledges understandability may be negatively affected when reinsurance contract cannot be treated as insurance contracts with direct participation features.

Coverage period

105 It has been noted that "for an underlying contract that is onerous, a cedant has to recognise a loss component through P/L whereas the relief from a corresponding reinsurance contract held has to be deferred over the coverage period."

106 EFRAG TEG has heard the argument that a direct insurance contract should not be considered onerous when the risk has been reinsured. This is based on an

interpretation of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* that defines an onerous contract based on the least net cost of *exiting* a contract. EFRAG TEG disagrees with this comparison and the conclusion that is drawn from it as by reinsuring a direct insurance contract, the insurer merely transfers (part of) its risk. Reinsurance does not imply that the insurer is freed from fulfilling its obligations under the contract.

107 In addition, EFRAG TEG acknowledges that he contractual service margin of a reinsurance contract held is seen as a net cost or net gain on the purchase of the reinsurance and is spread over the duration of the reinsurance contract. In contrast, when there is a loss at inception on the underlying insurance contracts, that loss is not deferred but accounted for in profit or loss immediately, thereby creating a mismatch.

108 Subject to the reinsurance contract and the underlying direct insurance contract having the same characteristics EFRAG TEG acknowledges that this results in an accounting mismatch which impacts the ability of the insurer to demonstrate that it has laid off part of its risk. In those cases, EFRAG TEG assesses that the mismatch reduces the relevance of information presented in the financial statements.

109 Subject to the reinsurance contract and the underlying direct insurance contract having the same characteristics, EFRAG TEG acknowledges that for the same reasons as described under relevance, the reliability of the resulting information may be negatively affected.

110 Based on the current netting practices in many local GAAPs between direct insurance contracts and reinsurance contracts held, EFRAG TEG acknowledges understandability may be negatively affected by accounting for a loss component for an onerous direct while deferring the profit from reinsurance over the coverage period.

Contract boundary

111 It has been noted that “contract boundaries for reinsurance are inconsistent with those of the underlying insurance contracts, meaning that the reinsurance accounting requires including an estimate of underlying insurance business that is not yet written/recognised.”

112 IFRS 17 requires insurance contracts issued and associated reinsurance contracts held to be treated as separate contracts. This implies that, in contrast to current practices, the contract boundary of reinsurance contracts held is determined independently of the underlying insurance contracts. As a result, the contract boundary of reinsurance contracts held may be shorter or longer than the underlying insurance contracts.

113 EFRAG TEG notes that entities need to use consistent assumptions for measuring reinsurance contracts held and related underlying insurance contracts. Nevertheless, situations may occur where contract boundaries differ between reinsurance contracts held and the underlying insurance contracts. For example, reinsurance contracts held may be repriced on a more frequent basis than the underlying insurance contracts. The IASB TRG noted that both rights and obligations need to be considered when assessing the boundary of a contract but adds that in the fact pattern discussed at the May 2018 TRG meeting the direct insurer had the right to terminate the contract when the reinsurer decided to reprice. EFRAG TEG assesses that determining the contract boundary of insurance and related reinsurance contracts separately provides relevant information as it reflects the different conditions of insurance contracts issued and reinsurance contracts held.

114 EFRAG TEG understands that the boundary of a reinsurance contract held could include cash flows from underlying contracts covered by the reinsurance contract that are expected to be issued in the future. Under IFRS 17, the direct insurance contracts and the reinsurance contracts held of a primary insurer are measured taking into account the expected cash flows of each contract.

115 EFRAG TEG considers that there may be a reduction in reliability in estimating contracts expected to be written in the future. However, EFRAG TEG:

(a) expects entities to have a budget or forecast which includes expected new business and to have past information on new business acquired even if at portfolio level or higher to provide a basis for estimation of the future cash flows; and

(b) notes that the estimation of these contracts would follow the same measurement principles as IFRS 17, i.e., probability-weighted estimate of the present value of cash flows.

116 Based on the current netting practices in many local GAAPs between direct insurance contracts and reinsurance contracts held, EFRAG TEG acknowledges understandability may be negatively affected by applying the separate contract boundaries of both the direct insurance contracts and the reinsurance contracts held, instead of using a look-through approach.

6. Scope of hedging adjustment

CFO Forum Presentation

Description of issue and evidence

~~86~~117 Whilst IFRS 17 includes a specific hedging adjustment, its use is limited to specific circumstances:

(a) It is only available for contracts in scope of the VFA

(b) It cannot be applied retrospectively on from the date of initial application

(c) It can only be used when derivatives are used as hedging instrument

~~87~~118 This was highlighted as part of the testing for a material book of business with guarantees that are hedged.

Implications

~~88~~119 The inability to use the hedge adjustment outside the narrowly defined scope will result in accounting mismatches if the fair value changes on hedging instruments are not recognised in the same category (P&L, OCI or CSM) as the changes on the hedged items). This will significantly distort the net result and create misalignment between accounting results and risk management. Paradoxically, a perfect hedge would cause a comparatively higher income statement volatility than a partial hedge.

IFRS 17

Requirements

~~89~~120 Hedge accounting is primarily within the scope of IFRS 9 *Financial Instruments* but IFRS 17 provides an optional risk mitigation accounting solution for VFA contracts.

IFRS 17, paragraphs B115, B116

~~90~~121 An insurer may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items or the fulfilment cash flows if the entity has a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:

(a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.

(b) an economic offset exists between the insurance contracts and the derivative, ie the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.

(c) credit risk does not dominate the economic offset.

IFRS 17, paragraphs BC54-BC55

122 Some stakeholders noted that the approach to accounting for risk mitigation activities in IFRS 17 does not fully eliminate accounting mismatches. In particular:

(a) some requested that the Board create a hedge accounting solution for insurance contracts without direct participation features;

(b) some noted that the Board is researching a model for dynamic risk management, and suggested aligning the projects; and

(c) some noted that the application of the risk mitigation requirements on a prospective basis would not eliminate accounting mismatches for relationships that started before the date of initial application.

123 The IASB's decisions on risk mitigation techniques related to insurance contracts with direct participation features reduce the accounting mismatches that were introduced by the VFA by providing an option to align the overall effect of the VFA more closely to the model for other insurance contracts (see paragraphs BC250–BC256). However, the IASB concluded that it would not be appropriate to develop a bespoke solution for all hedging activities for insurance contracts, noting that such a solution should form part of a broader project. The IASB did not want to delay the publication of IFRS 17 pending finalisation of that broader project. The IASB also concluded that a prospective basis was necessary for the application of the risk mitigation requirements on transition, for the reasons set out in paragraph BC393.

IFRS 17, paragraphs BC250 – BC255

~~91~~124 Amounts payable to policyholders create risks for an entity, particularly if the amounts payable are independent of the amounts that the entity receives from investments; for example, if the insurance contract includes guarantees. An entity is also at risk from possible changes in its share of the fair value returns on underlying items. An entity may purchase derivatives to mitigate such risks. When applying IFRS 9, such derivatives are measured at fair value.

~~92~~125 For contracts without direct participation features, the CSM is not adjusted for the changes in fulfilment cash flows the derivatives are intended to mitigate. Hence, both the change in the carrying amount of fulfilment cash flows and the change in the value of the derivative will be income statement. If the entity chooses to recognise all insurance finance income or expenses in profit or loss, there will be no accounting mismatch between the recognition of the change in the value of the derivative and the recognition of the change in the carrying amount of the insurance contract.

~~93~~126 For contracts with direct participation features the CSM would be adjusted for the changes in the fulfilment cash flows, including changes that the derivatives are intended to mitigate. Consequently, the change in the value of the derivative would be recognised in profit or loss, but, unless the group of insurance contracts was onerous, there would be no equivalent change in the carrying amount to recognise, creating an accounting mismatch.

~~94~~127 A similar accounting mismatch arises if the entity uses derivatives to mitigate risk arising from its share of the fair value return on underlying items.

~~95~~128 The IASB concluded that, to avoid such accounting mismatches created by the VFA, an entity should be allowed not to adjust the contractual service margin for the changes in the fulfilment cash flows and the entity's share in the fair value return on the underlying items that the derivatives are intended to mitigate.

~~96~~129 Such an option reduces the comparability of the measurement of insurance contracts because the contractual service margin will be adjusted by a different amount depending on whether, and the extent to which, an entity chooses to apply this approach. To limit the reduction in comparability, the Board decided that an entity may make this choice only to the extent that, in accordance with a previously documented risk management objective and strategy for using derivatives to mitigate financial market risk arising from those fulfilment cash flows

IFRS 17, paragraph BC393

~~97~~130 Paragraph B115 of IFRS 17 permits entities not to recognise a change in the contractual service margin for changes in fulfilment cash flows and the entity's share in the fair value returns on underlying items for which an entity uses derivatives to mitigate their financial risk. However, an entity applying this option is required to document its risk management objective and the strategy for mitigating the risk before doing so. This documentation requirement is analogous to the documentation requirements for hedge accounting in IFRS 9. Consistent with the transition requirements for hedge accounting in IFRS 9, the Board concluded that retrospective application of the risk mitigation treatment would give rise to the risk of hindsight. In particular, the Board was concerned that documentation after the event could enable entities to choose the risk mitigation relationships to which it would apply this option, particularly because the application of this approach is optional. Consequently, IFRS 17, consistent with the transition requirements for hedge accounting in IFRS 9, requires prospective application of the risk mitigation option from the date of initial application of the Standard.

Findings from the case study

~~98~~131 Number of respondents addressing the issue: 9

~~99~~132 One respondent made an estimate of the impact on the size of the CSM at transition of IFRS 17's prohibition on retrospective application of the optional risk mitigation solution for VFA contracts.

~~100~~133 Only one respondent expressed an intention to apply hedge accounting, whereas 7 stated that they did not expect to apply hedge accounting. One respondent noted they would consider whether to use hedge accounting.

~~101~~134 Reasons for not using hedge accounting are that derivatives are not generally used for hedging. Instead instruments such as mortality bonds or investments in special funds are used.

EFRAG TEG analysis

Summary

~~102~~135 EFRAG TEG acknowledges the issues raised in relation to hedge accounting but notes that many of the fact patterns provided in the case study demonstrate the need for a solution under the dynamic risk management (DRM) approach as being developed by the IASB as part of a separate project. EFRAG TEG considers that the lack of DRM solution today does not detract from IFRS 17's ability to meet the technical endorsement criteria.

~~103~~136 EFRAG TEG has sympathy with the concern on IFRS 17's prohibition on retrospective application of the optional risk mitigation solution for VFA contracts. EFRAG TEG assesses that permitting or requiring retrospective application might increase relevance (because it enables entities to more fully report the effect of certain risk management strategies in place at transition to IFRS 17) but could raise concerns over reliability (because entities might be able to 'cherry-pick' the hedging relationships to include in the designation at transition). EFRAG TEG notes that, although IFRS 9's transition provisions include a notion of 'continuing hedge relationships', hedging designations are generally prospective).

~~104~~137 EFRAG TEG expects that this issue will affect the relevance and reliability criteria of the standard.

The hedging adjustment is only available for contracts in scope of the VFA

138 IFRS 17 provides a risk mitigation approach for contracts with direct participation features. In order to apply this approach an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from insurance contracts. In the absence of this specific risk mitigation, the changes in the effect of financial risk on the entity's share of the underlying items and on financial guarantees would be recognised in the contractual

service margin. However, the derivative used to mitigate this financial risk would be measured at fair value through profit or loss giving rise to an accounting mismatch. Therefore, EFRAG TEG assesses that the risk mitigation approach for contracts with direct participation features addresses a particular set of accounting mismatches.

139 This reasoning is not applicable for some indirect participation contracts (i.e. those that have some characteristics of participation contracts but do not meet the definition of contracts with direct participation features). These insurance contracts are accounted for under the general model where changes in the effect of financial risk on the entity's share of the underlying items and on financial guarantees are recognised in the statement of comprehensive income. This accounting allows for an application of the hedge accounting requirements of IFRS 9.

140 However, it is argued by some that the hedge accounting requirements of IFRS 9 cannot be relied upon to address the accounting mismatches that can occur with some indirect participation contracts because:

(a) the risk component (hedged item) cannot be separately identified and cannot be reliably measured for those contracts where investment and insurance components are highly interrelated. In addition, policyholder behaviour and other future expectations (for example lapses, surrenders, new business sales, mortality) are correlated with the impact of financial market variables and it is difficult to exclude these from the hedging relationship;

(b) entities hedge their risks on an open portfolio basis, not on a closed portfolio basis, whereas the aggregation requirements of IFRS 17 create closed portfolios; and

(c) entities hedge also changes in future mortality expectations that affect the contractual service margin rather than profit or loss or other comprehensive income.

141 In assessing the absence of a risk mitigation solution for indirect participation contracts, EFRAG TEG notes that when risk components of insurance contracts cannot be separately identified or reliably measured, the creation of a hedge accounting relationship would not lead to reliable information because it would be impossible to assess the effectiveness of the entity's hedging strategy. Hence, EFRAG TEG assesses that the absence of a hedge accounting solution for features of indirect participation contracts does not reduce the reliability of the resulting information.

142 In assessing the absence of a risk mitigation solution for indirect participation contracts, EFRAG TEG notes that when the resulting information is unreliable, as assessed above, it is also not relevant for financial reporting purposes.

The hedging adjustment cannot be applied retrospectively on from the date of initial application

143 IFRS 17 does not allow retrospective application of the risk mitigation requirements on transition. Some consider that this reduces reliability of the transition numbers as amounts relating to reducing risks before transition are treated differently to those after transition. In assessing this view, EFRAG TEG notes that:

(a) entities do not always have detailed historical information about their insurance contracts;

(b) some entities have historical information available for their hedging relationships but only at an aggregated level. Retrospective application would raise practical issues on how to assign such amounts to groups of insurance contracts being hedged; and

(c) concerns about retrospective application relate to the determination of the equity position when transitioning to IFRS 17.

144 EFRAG TEG understands that when insurers have previously been using economic hedging to reduce their risks, these insurers would prefer to report the effect of these hedging activities on transition to IFRS 17. EFRAG TEG assesses that the prohibition of doing so does not result in relevant information.

145 However, EFRAG TEG also assesses that in applying risk mitigation retrospectively an entity could need to use hindsight when allocating the hedging gains or losses to groups of insurance contracts. The use of hindsight is reinforced because of the absence of detailed historical information and the use of hedging gains or losses at aggregated level. EFRAG TEG assesses that such an approach would not lead to reliable information.

The hedging adjustment can only be used when derivatives are used as hedging instrument

146 It is noted by some that risk mitigation is done not only by using derivatives but also other financial instruments such as mortality bonds or investments in special funds. EFRAG TEG acknowledges the use of this type of hedging instruments. By not recognising the use of this type of hedging instruments IFRS 17 risk mitigation reduces the relevance of the resulting information.

147 EFRAG TEG is also of the view that not recognising the use of this type of hedging instruments IFRS 17 risk mitigation reduces the reliability of the resulting information as it does not permit to faithfully report on the hedging activities undertaken.

7. Scope of the VFA model vs General model and PAA

CFO Forum Presentation

Description of issue and evidence

~~105~~148 The testing has shown that the results are very different depending on the measurement model applied, whilst there is a continuum in the nature of insurance products. There are several elements in the VFA model that deal more appropriately with specific elements of insurance products but these are not available under the general model or premium allocation approach. These include the alignment between liability discount rates with (accounting for) asset returns and the transitional amount in OCI.

Implications

~~106~~149 The result is that insurance contracts that are economically similar will be accounted for very differently, which does not reflect economic reality. The significant differences between the models create 'cliff effects' that are very dependent on the interpretation of the scope definitions of the different models.

IFRS 17

Requirements

Definitions

~~107~~150 **VFA**: An insurance contract for which, at inception:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns on the underlying items; and

(c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

~~108~~151 **PAA**: An entity may simplify the measurement of a group of insurance contracts using the PAA if, at the inception of the group:

(a) the entity reasonably expects that such simplification would produce a measurement of the liability for remaining coverage for the group that would not differ materially from the one that would be produced applying the general; model; or

(b) the coverage period of each contract in the group (including coverage arising from all premiums within the contract boundary determined at that date is one year or less.

Basis for Conclusions

VFA: IFRS 17, paragraphs BC231, BC239, BC241

~~109~~152 The VFA was developed for contracts that create an obligation to pay policyholders an amount equal in value to specified underlying items, minus a variable fee for service. These contracts are distinguished from those where the entity controls the cash flows of the investments, even when the entity is required to act in a fiduciary capacity for the policyholder.

~~110~~153 The IASB concluded that for many insurance contracts it is appropriate to depict the gains and losses on any investment portfolio related to the contracts in the same way as gains and losses on an investment portfolio unrelated to insurance contracts.

PAA: IFRS 17, paragraphs BC291

~~111~~154 The IASB views the PAA as a simplification of those general requirements. To simplify its application, the IASB also decided to provide guidance that an entity could assume, without further investigation, that the approach provides a reasonable approximation of the general requirements of IFRS 17 if the coverage period of each contract in the group is one year or less.

Findings from the case study

~~112~~155 Number of respondents addressing the issue: 7.

~~113~~156 The reasons provided for not being able to use the VFA where the entity considered that the VFA would have been appropriate were that:

(a) The insurance contract contained a constructive obligation rather than a contractual obligation. It was acknowledged that the link to underlying items was not enforceable. It was also noted that the insurance contract only relates to contracts issued within a specific jurisdiction.

(b) A substantial portion of the amount paid to policyholders does not vary with a change in the fair value of the underlying items.

(c) Assets were held in a general fund rather than being identifiable underlying items.

~~114~~157 Three respondents explained why, in their view, the general model does not reflect their business model. Only one of the three respondents provided detailed information on the relevant portfolio and quantified the impact.

~~115~~158 Four respondents did not provide quantified evidence to support their view that the CSM pattern under the general model does not reflect their business model. Another four respondents did not provide any information.

EFRAG TEG analysis

~~116~~159 EFRAG TEG acknowledges that scoping decisions need to be made when an accounting standard includes multiple models and that this inevitably has the effect that contracts on different points on a continuum are accounted for differently. A cliff effect will only arise with the PAA in the case of a contract with a term of one year or less and can be avoided by not adopting the PAA.

~~117~~160 If the scope of the VFA were to be amended this would move the “cliff” rather than eliminating it. Further, if the scope were to be extended to contracts that do not specify a clear link between the payments to policyholders and the returns on an identifiable pool of assets it is unclear how the VFA would operate (because the VFA involves deferring a specified amount of investment gain/loss into the CSM). This is especially problematic when the assets in concern are held in a general fund~~.~~ where the link to a clearly identified pool of underlying items could be difficult to demonstrate.

161 Some argue that certain contracts with discretionary payments made to the policyholder, are economically similar in nature to insurance contracts with direct participation features even though the obligation to make payments is not contractual. Therefore, assuming that the other requirements in IFRS 17 are met, they argue that these types of contracts should be accounted for under the approach for contracts with direct participation features.

162 EFRAG TEG notes that contracts where ambiguity could arise include contracts with constructive obligation(s) and contracts that only meet one or two of the VFA scope criteria.

163 EFRAG TEG assesses that a contract condition can arise because of a constructive obligation but that not all constructive obligations would give rise to contract conditions and, therefore, do not necessarily result in financial liabilities. EFRAG TEG acknowledges that whether an enforceable contractual right or obligation exists is a question to be considered within the context of the relevant legal framework. Consequently, the factors that determine enforceability may differ between jurisdictions. Therefore, in order to demonstrate that discretionary payments made to the policyholder under an insurance contract are within the scope of the VFA the contract should have contractual terms that are enforceable. EFRAG TEG also acknowledges that the legal implications of past business practice need to be considered.

164 EFRAG TEG also notes that under IAS 32 *Financial Instruments: Presentation* contracts which grants the issuer discretion over payments to be made are not treated in the same way as contracts without such discretion.

~~118~~165 Consequently, EFRAG TEG considers that IFRS 17's requirements on eligibility for the VFA and PAA approaches are reasonable and will contribute positively to the following technical endorsement criteria:

(a) Relevance – The VFA model deviates from the GM and was specifically designed for contracts that create an obligation to pay policyholders a substantial part of the fair value of specified underlying items, minus a variable fee for service.

(b) Understandability – The PAA is a simplification of the GM which provides a reasonable approximation of the general requirements of IFRS 17 if the coverage period of each contract in the group is one year or less.

(c) Comparability - EFRAG TEG assesses that, if contractual terms are not enforceable, the fact that the VFA approach for contracts with direct participation features cannot be applied, does not hinder comparability.